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Under Pressure – softening outlook keeping central banks at bay

Against an over-heating economic backdrop, even good data can be bad news. Persistent upside surprises on the US economy, including a blockbuster reading for Q3 GDP growth reinforced the view that it might take a longer period of restrictive monetary policy to get inflation in the US sustainably back under control – delaying but not preventing a slowdown in the economy. Interest rates on US government bonds increased throughout October alongside a rise in term premiums, and steeper yield curve.

That was until last week, when Fed's decision to hold key rates steady for a second time in a row sent markets rallying. The gains were then extended by a softer-than-expected employment report later in the week. 10-year treasury yield dropped sharply over the week, and the yield curve flattened, reversing some of the steepening earlier in fall.

The outlook elsewhere is gloomier. GDP growth in the euro area contracted slightly in Q3 and conditions in the UK looks on track for a similar sized decline in the same quarter. There are growing signs that the Canadian economy is buckling under the weight of higher interest rates and prices. The U.S. dollar held on to broadly based appreciation over the last month, while CAD underperformed as the economic backdrop softens ahead of the other economies.

Inflation readings are still high in Canada, euro area and the U.K., but are on balance moderating. Central banks will remain ultra-cautious about taking their feet off the economy's brakes too quickly. But softer economic growth numbers today mean slower inflation tomorrow and should reinforce expectations that central banks are done hiking interest rates for this cycle. We expect most central banks (with the RBA one notable exception) to hold rates steady before pivoting to gradual cuts starting with the Fed in the second quarter of 2024.

Overview

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Central bank bias

Central bank	Current policy rate (latest move)	Next move
BoC	**5.00%** +0 bps in Oct-23	**0 bps** in Dec-23

The BoC again left the overnight rate unchanged at 5% in October, amid more signs of softening economic growth (GDP's tracking another small quarterly decline in Q3) and slowing hiring activities. We continue to look for weaker demand to slow inflation, keeping the BoC on hold in the current cycle.

Central bank	Current policy rate (latest move)	Next move
Fed	**5.25-5.50%** +0 bps in Nov-23	**0 bps** in Dec-23

After two skips in the interest rate decisions, the Fed now looks to be officially on hold. The press release accompanying the November announcement highlighted strong economic growth but also significantly tighter financial conditions. Labour demand is cooling, and inflation readings remained muted overall. We don't see the Fed moving rates any higher in the current cycle.

Central bank	Current policy rate (latest move)	Next move
BoE	**5.25%** +0 bps in Nov-23	**0 bps** in Dec-23

Inflation in the U.K., especially in the closely watched services components, remained elevated in September. Still, weaker services activities according to the PMIs and ongoing deterioration in labour market conditions all suggest that domestic price pressures should keep receding. We see the BoE holding the Bank Rate steady from this point forward, at 5.25% through 2024.

Central bank	Current policy rate (latest move)	Next move
ECB	**4.00%** +0 bps in Oct-23	**0 bps** in Dec-23

The ECB in October left the deposit rate unchanged and noted "striking" evidence of the "forceful" transmission of monetary policy. Bank lending for both mortgage and corporate loans kept pulling back. Survey data has also continued to point to contractions in output. We don't see the ECB moving rates higher and expect the 4% deposit rate to be held through 2024.

Central bank	Current policy rate (latest move)	Next move
RBA	**4.35%** +25 bps in Nov-23	**0 bps** in Dec-23

An upside surprise in the Q3 inflation report promoted the RBA in November to move the cash rate up by 25bps, to 4.25% currently. Hurdles against another rate hike in the near-term are still very high. But tangible risks of an extended inflation overshoot also remain. We expect the RBA to pause in December, before taking the cash rate higher by another 25bps to the terminal of 4.60%.

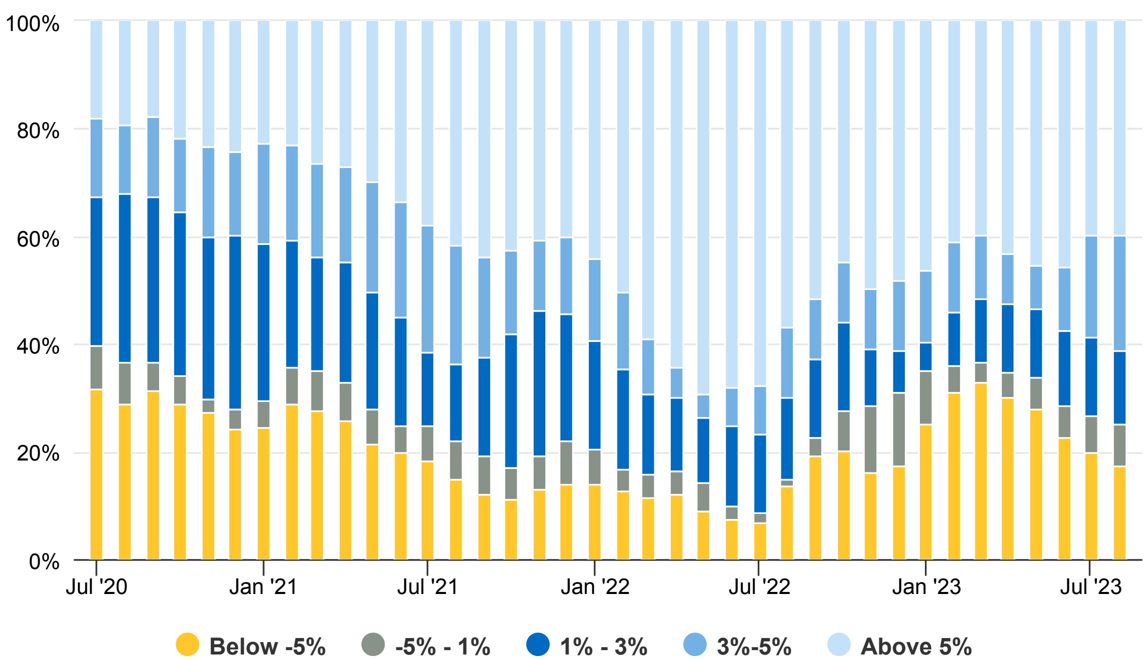
Excess demand disappearing in Canada as spending slows

Evidence continues to build that the Canadian economy is losing steam. Early estimates from Statistics Canada are pointing to a (second consecutive) small decline in Q3 GDP – led by a pull-back in consumer-sensitive sectors like retail and restaurant sales, as well as lower manufacturing output. Taking into account surging population growth, GDP per-capita looks on track to decline a similar amount in Q3 as the 3 ½% annualized drop in Q2, marking a fifth straight quarterly drop.

Employment has continued to rise, but not fast enough to prevent a significant 0.7 percentage point rise in the unemployment rate to 5.7% in October from 5.0% in April. Growth in wages has yet to moderate persistently but businesses expect pay increases to slow in the year ahead, according to the Bank of Canada's own Business Outlook Survey for Q3.

Breadth of inflation pressures still wide but showing improvement

Share of CPI basket by annualized growth of average 3 month change



Source: Statistics Canada, RBC Economics

Indeed, the BoC estimated that the economy-wide output gap (the gap between the current level of GDP and the level that would be consistent with the target 2% inflation rate) is already much closer to zero. Inflation readings are still running above target but will slow as the economic backdrop softens. Our own CPI diffusion index suggests the breadth of price pressures is still wide, but are showing improvements – a growing share of consumer basket is starting to see mid-range (3% - 5%) instead of very high (5%+) inflation readings, with close to 20% of the basket seeing outright declines in prices on a 3-month annualized basis.

Absent a larger pick-up in inflation readings and with GDP growth still expected to trend below the "potential" rate for some time, we see little prospects for the Bank of Canada to move the overnight rate higher again and expect them to start cutting in the second half of next year.

Growth momentum in the U.S. still strong but not expected to persist

A resilient U.S. economy over the summer was largely overlooked when the Federal Reserve decided to hold the fed funds target range at 5.25% -5% for a second meeting in a row in November (and the third in the last four that the central bank opted to forego a hike.)

Consumer spending has been incredibly resilient, accelerating in Q3 despite higher interest rates and still elevated prices. But robust consumption has been financed in part via households spending more out of their current income than they used to, and accumulating less savings. That is not expected to persist, especially when the household income growth backdrop is getting murkier as labour market conditions deteriorate. Employment growth has remained relatively firm. But wage growth has slowed persistently. The 0.4 percentage point increase in the US unemployment rate over a 3-month period is also rare and has usually only happened at the start of a labour market downturn.

U.S. unemployment rate ticking higher persistently

3-month percentage point change, shaded areas indicate recession

Source: Bureau of Labor Statistics, RBC Economics

Fed officials remain concerned about inflation. Moving forward a dimming economic and labour market outlook should continue keep a lid on price increases, in part balancing out risks of easing financial conditions as yield curve will likely give back more of the aggressive steepening over the recent months. We don't see the Fed hiking more this year and expect them to start gradually moving key rates lower in the second quarter of 2024.

Softer service activities keeping the ECB and BoE on the sidelines

Elsewhere in euro area and the UK, softening trends in economic growth are persisting. GDP contracted slightly in Q3 in the euro area, and we look for similar sized decline in output for the UK over the same quarter (-0.2%). Early PMI data for October suggests the softness was carried over to Q4. Indeed, cooling goods demand has been putting downward pressure on manufacturing activities in these regions since mid-2022.

Activity in the service sector has been more resilient, but that momentum is also starting to wane over the past months, according to the PMIs data. Softening activities across sectors is also starting to feed through to slower labour market conditions. The unemployment rate has already started to creep higher in the UK should start to very soon in the euro area, as hiring demand cools.

The good news is that slower demand should allow inflation to keep slowing, thereby reducing pressure on central banks to push interest rates higher. The ECB and the BoE both held key interest rates steady in their latest meetings over the past two weeks. Similar to Canada, a rapidly deteriorating macroeconomic backdrop coupled with signs of softening labour market conditions in these regions suggest that inflation will more likely continue to moderate rather than reaccelerate. We expect both the ECB and the BoE will hold rates at currently high levels until the second half of 2024, when they start to pivot at a gradual pace.

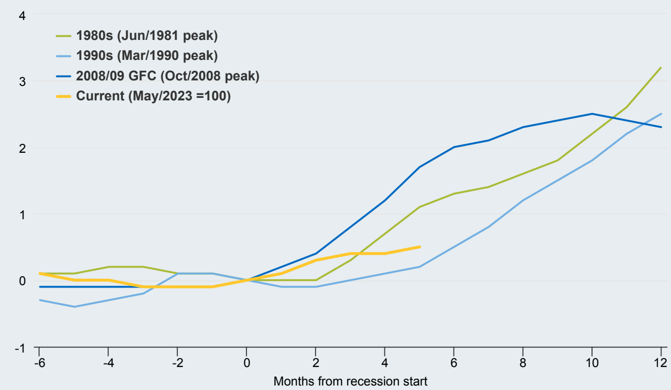
Being mindful of the downside: Canadian households are vulnerable to softer labour markets

The evidence is building that the Canadian economy is in the early stage of a "mild" contraction. The rise in the unemployment rate to-date has been driven by longer job search time rather than reduced hours or outright layoffs. Still, that is typically what the early stage of a labour market slowdown looks – average hours worked have largely flatlined. Canadian GDP on a per-capita basis and the unemployment rate are also tracking a path consistent with, but on the 'mild' range, of early-stage economic contractions historically.

Still, risks remain that conditions could get worse. Household spending remained resilient through more than a year of aggressive interest rate increases and high inflation. But household debt servicing costs are already at record highs, and remaining pandemic savings are concentrated at the top end of the income scale and have shifted into term deposits that are less likely to be spent. With more impact of interest rate increases still to be delivered, Canadian households are starting to look more vulnerable to income losses at a time when labour markets already look wobbly.

Canada Unemployment Rate Recession Comparison

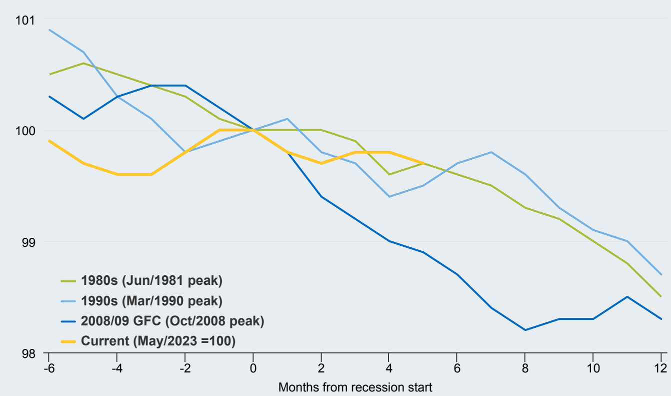
PPT increase, 3-month rolling average



Source: Statistics Canada, RBC Economics

Canada Hours Worked per Person Recession Comparison

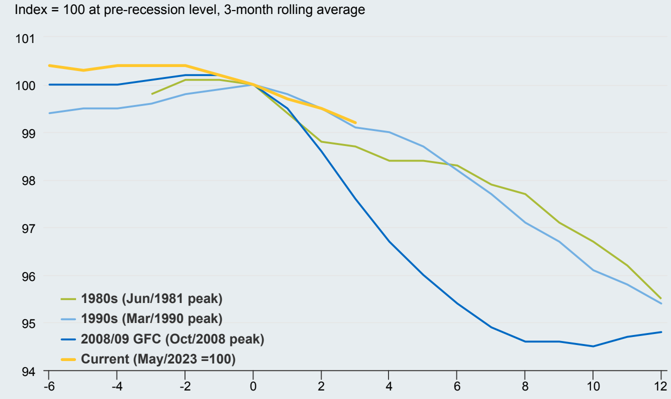
Index = 100 at pre-recession level, 3-month rolling average



Source: Statistics Canada, RBC Economics Research

Canada per-capita GDP Recession Comparison

Index = 100 at pre-recession level, 3-month rolling average



Source: Statistics Canada, RBC Economics Research

Interest rate outlook

Policy rates and government bond yields, end of period

	Q1-22	Q2-22	Q3-22	Q4-22	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24
Canada												
Overnight rate	0.50	1.50	3.25	4.25	4.50	4.75	5.00	5.00	5.00	5.00	4.50	4.00
Three-month	0.60	2.08	3.59	4.23	4.34	4.90	5.07	5.00	4.95	4.85	4.35	3.85
Two-year	2.27	3.10	3.78	4.06	3.74	4.58	4.87	4.50	4.20	3.85	3.60	3.40
Five-year	2.39	3.10	3.30	3.41	3.02	3.68	4.25	3.90	3.60	3.40	3.35	3.30
10-year	2.40	3.23	3.15	3.30	2.90	3.26	4.03	3.80	3.65	3.50	3.40	3.35
30-year	2.37	3.14	3.11	3.28	3.02	3.09	3.81	3.70	3.65	3.60	3.60	3.55
United States												
Fed funds midpoint	0.38	1.63	3.13	4.38	4.88	5.13	5.38	5.38	5.38	5.13	4.63	4.13
Three-month	0.52	1.72	3.33	4.42	4.85	5.43	5.55	5.30	5.23	4.93	4.43	3.93
Two-year	2.28	2.92	4.22	4.41	4.06	4.87	5.03	4.80	4.55	4.05	3.70	3.40
Five-year	2.42	3.01	4.06	3.99	3.60	4.13	4.60	4.40	4.20	3.85	3.65	3.50
10-year	2.32	2.98	3.83	3.88	3.48	3.81	4.59	4.50	4.40	4.20	4.05	3.95
30-year	2.44	3.14	3.79	3.97	3.67	3.85	4.73	4.70	4.65	4.55	4.50	4.45
United Kingdom												
Bank rate	0.75	1.25	2.25	3.50	4.25	5.00	5.25	5.25	5.25	5.25	5.25	5.25
Two-year	1.36	1.85	4.29	3.71	3.42	5.27	4.91	5.00	4.95	4.90	4.75	4.50
Five-year	1.40	1.88	4.40	3.62	3.33	4.66	4.53	4.50	4.35	4.10	4.00	3.80
10-year	1.60	2.22	4.08	3.67	3.47	4.39	4.46	4.50	4.40	4.30	4.25	4.25
30-year	1.77	2.59	3.82	3.95	3.82	4.42	4.92	5.00	4.90	4.75	4.75	4.75
Euro area*												
Deposit Rate	-0.50	-0.50	0.75	2.00	3.00	3.50	4.00	4.00	4.00	4.00	4.00	4.00
Two-year	-0.08	0.64	1.78	2.76	2.66	3.27	3.20	3.25	3.25	3.15	3.00	2.75
Five-year	0.37	1.09	1.98	2.58	2.30	2.58	2.79	2.90	3.00	2.85	2.75	2.60
10-year	0.55	1.36	2.12	2.57	2.28	2.39	2.85	3.00	3.15	3.00	2.90	2.90
30-year	0.67	1.63	2.10	2.46	2.35	2.38	3.05	3.10	3.25	3.10	3.00	3.00
Australia												
Cash target rate	0.10	0.85	2.35	3.10	3.60	4.10	4.10	4.35	4.60	4.60	4.60	4.60
Two-year	1.78	2.73	3.43	3.41	2.97	4.18	4.11	4.10	4.00	3.85	3.75	3.70
10-year	2.84	3.67	3.89	4.05	3.30	4.03	4.48	4.50	4.55	4.40	4.30	4.15
New Zealand												
Cash target rate	1.00	2.00	3.00	4.25	4.75	5.50	5.50	5.50	5.50	5.00	4.50	4.00
Two-year swap	3.27	4.06	4.76	5.36	5.01	5.46	5.69	5.20	5.00	4.80	4.30	3.80
10-year swap	3.38	4.10	4.50	4.78	4.27	4.46	5.13	5.05	4.80	4.60	4.40	4.25

Sources: Refinitiv, BoC, Fed, BoE, ECB, RBA, RBNZ, RBC Economics, RBC Capital Markets | *German government bond yields

Economic outlook

Real GDP, quarter-over-quarter percent change

	Q1-22	Q2-22	Q3-22	Q4-22	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	2021	2022	2023	2024
Canada*	2.6	3.6	2.3	-0.1	2.6	-0.2	-0.5	-0.5	0.3	1.4	2.0	2.6	5.0	3.4	1.0	0.6
United States*	-2.0	-0.6	2.7	2.6	2.2	2.1	4.9	0.5	-1.0	-1.0	1.0	1.5	5.8	1.9	2.4	0.6
United Kingdom	0.5	0.1	-0.1	0.1	0.3	0.2	-0.1	-0.2	0.0	0.1	0.2	0.2	8.7	4.3	0.4	0.1
Euro area	0.7	0.8	0.3	0.0	0.0	0.2	-0.1	-0.1	0.0	0.1	0.1	0.2	5.9	3.4	0.4	0.1
Australia	0.6	0.7	0.7	0.7	0.4	0.4	0.2	0.1	0.3	0.4	0.5	0.6	5.2	3.7	1.8	1.2

*annualized

Inflation, year-over-year percent change

	Q1-22	Q2-22	Q3-22	Q4-22	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	2021	2022	2023	2024
Canada	5.8	7.5	7.2	6.7	5.1	3.5	3.7	2.8	2.7	2.2	1.4	1.6	3.4	6.8	3.8	2.0
United States	8.0	8.6	8.3	7.1	5.8	4.0	3.5	3.4	2.9	2.8	2.5	2.2	4.7	8.0	4.1	2.6
United Kingdom	6.2	9.2	10.0	10.8	10.2	8.4	6.7	4.9	4.2	2.5	2.7	2.3	2.6	9.1	7.6	2.9
Eurozone	6.1	8.0	9.3	10.0	8.0	6.2	5.0	3.3	3.2	3.0	2.7	2.7	2.6	8.4	5.6	2.9
Australia	5.1	6.1	7.3	7.8	7.0	6.0	5.4	4.4	4.0	4.1	3.6	3.4	2.9	6.6	5.7	3.8

Sources: StatCan, BLS, ONS, EuroStat, ABS, RBC Economics, RBC Capital Markets

Currency outlook

US dollar cross rates, end of period

	Q1-22	Q2-22	Q3-22	Q4-22	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24
USD/CAD	1.25	1.29	1.38	1.35	1.35	1.32	1.35	1.38	1.39	1.39	1.35	1.31
EUR/USD	1.11	1.05	0.98	1.07	1.09	1.09	1.06	1.04	1.03	1.02	1.05	1.08
GBP/USD	1.32	1.22	1.11	1.21	1.24	1.27	1.22	1.17	1.13	1.11	1.15	1.20
USD/JPY	121	136	145	132	133	144	149	150	152	154	150	145
AUD/USD	0.75	0.69	0.64	0.68	0.67	0.67	0.65	0.62	0.61	0.60	0.61	0.62

Canadian dollar cross rates

	Q1-22	Q2-22	Q3-22	Q4-22	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24
EUR/CAD	1.39	1.35	1.34	1.45	1.47	1.44	1.43	1.44	1.43	1.42	1.42	1.41
GBP/CAD	1.64	1.57	1.51	1.63	1.67	1.68	1.65	1.61	1.57	1.54	1.56	1.57
CAD/JPY	97	105	105	97	98	109	110	109	109	111	111	111
AUD/CAD	0.94	0.89	0.89	0.92	0.91	0.88	0.87	0.86	0.85	0.83	0.82	0.81

Sources: Federal Reserve Board, Bank of Canada, RBC Economics, RBC Capital Markets